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No. 614

In the Supreme Court of the United States

OCTOBER TERM, 1962

PANHANDLE EASTERN PIPE LINE COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

[redacted]

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OPINIONS BELOW

The opinion of the Court of Appeals for the District of Columbia Circuit (Pet. App., pp. A1–A9), is reported at 305 F. 2d 763. Its prior opinion setting aside the Commission's previous order is reported *sub nom. City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810, certiorari denied, 352 U.S. 829. The present opinions of the Commission (R. 422–455, 486–494, 562–569) are reported at 25 F.P.C. 787, 1215, 784 and 1214, respectively; its previous opinion (printed in part at R. 502–561) is reported at 13 F.P.C. 53.

JURISDICTION

The judgment of the Court of Appeals, affirming the Commission's orders in part and remanding them for further proceedings on an issue not raised here, was entered on June 30, 1962 (Pet. App., p. A10). By order of Mr. Justice Black, the time for filing a petition for a writ of certiorari was extended to November 27, 1962. The petition for a writ of certiorari was filed on November 26, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in fixing rates for a natural gas pipeline company, the Commission had a reasonable basis for concluding that the company had not justified the allowance of the weighted average field price for its own production of gas.

STATUTE INVOLVED

The pertinent provisions, Section 4(e), 15 U.S.C. 717c(e), and Section 5(a), 15 U.S.C. 717d(a) of the Natural Gas Act, are set forth in the Appendix, *infra*, pp. 19–21.

STATEMENT

The court below affirmed, with one exception not in issue here, two Commission orders disallowing increased rates collected subject to refund by Panhandle Eastern Pine Line Company during the periods from February 20, 1952, to December 31, 1954, and from January 1, 1955, to August 31, 1958. The Commission orders required Panhandle to file lower substitute rates for those periods and to make refunds of the

difference between the rates collected and those found to be just and reasonable.[1]

The proceeding involving the 1952–1954 rates had been remanded to the Commission by the Court of Appeals for the District of Columbia Circuit in *City of Detroit* v. *Federal Power Commission,* 230 F. 2d 810, certiorari denied, 352 U.S. 829. The April 15, 1954, order there reviewed had allowed about $12,780,000 of a $21,400,000 annual increase sought by Panhandle (R. 557–558). In approving the increase to that extent, the Commission (1) permitted Panhandle to include in its cost of service the so-called "field price" or "commodity value" (*i.e.*, the weighted average price then being paid independent producers in each of the same areas) of its own produced gas, instead of merely allowing the cost of producing the gas, as it would under the conventional cost of service-rate base method; and (2) treated Panhandle's profitable gasoline extraction operations at Sneed, Texas, and Liberal, Kansas, as outside its jurisdiction, including neither the costs nor the revenues of those operations in determining Panhandle's rates within its jurisdiction (R. 508–546). The court of appeals in *City of Detroit* remanded on the ground that the record and findings did not support those rulings (230 F. 2d at 823).

[1] The rates here involved were superseded on September 1, 1958, by still higher rates (R. 446), which, were, in turn, superseded by increased rate filings on March 26, 1960 and July 1, 1960. By order of July 20, 1962, the Commission approved a settlement which, except for one issue not here involved, terminated the proceedings relating to the three filings subsequent to those here at issue, lowered Panhandle's current rates, and resulted in refunds of $38,500,000 plus interest.

As the court noted, the reasons given by the Commission in 1954 for allowing Panhandle to attribute to the gas produced by it the totally unregulated weighted average field price, rather than the actual cost of finding and producing, were that the traditional cost of service method (1) tended unduly to accelerate consumption of gas, (2) did not sufficiently encourage its discovery and development, and (3) did not provide adequate incentive for the ownership of gas reserves by pipeline companies, which it deemed to be in the public interest. See 230 F. 2d at 816. While rejecting contentions by consumer interests that just and reasonable rates under the Natural Gas Act could be determined only by use of the traditional cost of service-rate base method, the court held that the Commission had not sufficiently correlated its reasons for using field price with the evidence,[2] stating (230 F. 2d at 817–818):

> While as we have indicated the Commission may be empowered to consider some of these factors it must also, and always, relate its action to the primary aim of the Act to guard the consumer against excessive rates. *If the Commission contemplates increasing rates for the purpose of encouraging exploration and development, or the ownership by pipeline companies of their own producing facilities, it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose.* Further than this we think the Commission

[2] It also held that it was improper for the Commission to consider the effect of the rate level on the volume of gas consumed (230 F. 2d at 816–817).

cannot go without additional authority from Congress.

> The amount allowed Panhandle for the encouragement referred to is not shown to meet this test by any evidence and findings. *Of course the rate increase attributable to producing properties might have a tendency to encourage their ownership, and perhaps also the development of new sources of production, as an even greater increase also might do. But the question is whether a lesser amount would suffice.* The amount here allowed is not brought into relationship by the evidence and findings with the purposes for which it is granted except that it affords a larger revenue to Panhandle than otherwise it would have. This is not an adequate basis for bringing the resulting rates within the "just and reasonable" standards of the Act. * * * [Emphasis added.]

In addition, the court said that "it is essential in such a case as this" to use the rate base approach "at least as a point of departure." 230 F. 2d at 818–819.

Prior to the decision and remand in the *City of Detroit* case, Panhandle had filed a new set of rates which would have resulted in annual revenues of about $12 million in excess of those approved by the Commission for the earlier period (R. 423). These increased rates were suspended until January 1, 1955. On December 13, 1954, the Commission issued an interim order dismissing the rates to the extent they reflected proposed revisions in Panhandle's rate of return, working capital, allocation of costs and rate structure. As to these items, the Commission found

that the company had shown no change in circumstances or other justification for departing from the Commission's findings with respect to the 1952–1954 refund period. This interim rate reduction order (which led Panhandle to file and collect, subject to refund, substitute rates designed to yield about $5 million less than the rates originally proposed) was affirmed by the Third Circuit. *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission,* 236 F. 2d 606. Cf. *Federal Power Commission* v. *Tennessee Gas Transmission Co.,* 371 U.S. 145.

Extensive hearings on the second increase, as modified, were resumed prior to the remand in *City of Detroit* and were completed in January, 1957 (Pet. App. A3). In February, 1959, the hearing examiner rendered a decision holding, *inter alia,* that Panhandle had failed to justify an allowance for its own production greater than that arrived at by the traditional rate base method (Pet. App. A3, 25 F.P.C. 805). Upon motion of Panhandle, the Commission, by order of January 14, 1960, reopened the proceeding to permit the company to present additional evidence on that issue (Pet. App. A3, R. 409–417).

The Commission then waived further intermediate decision by the hearing examiner (R. 418–422) and, after oral argument, issued its opinion and order on April 27, 1961 (R. 422–455). At the same time the Commission issued its opinion and order in the remanded proceedings (R. 562–566) on the 1952–1954 rates, in which, having taken no additional evidence, it relied principally on the opinion relating to the rates for the later period.

In its principal opinion, the Commission concluded, with respect to the single issue presented here, that Panhandle had not submitted evidence justifying the claimed commodity value allowance for company-produced gas, which would have increased the allowance for Panhandle's production during the 44-month 1955–1958 refund period by more than $20 million. In so concluding, the Commission rejected the various bases on which Panhandle attempted to justify an allowance in excess of its cost during the agreed-upon test year (the year ending October 31, 1954). It held that evidence of a hypothetical program of future expansion during 1960–1964 was not competent to test the rates in effect from January 1, 1955, through August 31, 1958 (R. 430–431). However, the Commission adjusted the examiner's test year allowance for exploration and development by raising it to the average amount actually spent during the test year and up to the end of the subsequent refund period, noting that the examiner's allowance for exploration and development was less than that actually expended on an annual basis during the 44-month refund period (R. 432–433). It stated, moreover, that if it were "setting rates for the future, we would not necessarily hold a natural-gas company to expenditures confined to the test year" (R. 430).

The Commission also held that Panhandle had not justified the claim of commodity value for its produced gas by adducing evidence to show that the public interest would have been served if it had engaged in additional exploration and development during the

refund period, but that it had not undertaken the hypothetical program because it did not know how much the Commission would allow for its produced gas (R. 428–430, 487–488). The Commission found unpersuasive Panhandle's contention that allowance of a weighted average field price would save future consumers large amounts by furnishing the company an incentive to produce from its own reserves, rather than to buy gas on the market at current prices much higher than the weighted average price. The Commission noted that this claim of future consumer benefits ignored the higher current rates which allowance of commodity value would cause consumers to pay (R. 431).

The court below, in affirming the Commission's allowance of adjusted cost for company-produced gas, held that the Commission was not "obliged on the record made to grant a larger allowance than it did" (Pet. App. A6) and pointed out that the Commission had "left the door open for a more liberal treatment in future years on a more persuasive record" (Pet. App. A6). The court also held that the Commission was certainly "entitled to reject the claim based on hypothetical development costs *not* actually incurred" (Pet. App. A6). The court overruled Panhandle's claim that the Commission had rejected its non-cost evidence through a misunderstanding of the court's *City of Detroit* opinion. In this connection, it commented that the record made "clear that Panhandle would not commit itself to undertake an expanded program of future exploration and development unless the field price or its equivalent was allowed by the Commis-

sion for the gas produced during the refund period" (Pet. App. A6).[3]

ARGUMENT

1. Panhandle argues that the court's decision here (and also its holding in *City of Detroit*) in effect imposed the "cost rate base formula" as the sole means for pricing the company's own production of gas, and therefore conflicted with the same court's later holding in *Wisconsin* v. *Federal Power Commission*, 303 F. 2d 380 (C.A.D.C.), pending on certiorari, Nos. 72, 73, 74, this Term, and with decisions of this Court, such as *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, giving the Commission wide latitude in devising ratemaking formulae (Pet. 9–17). The short answer is that this contention wholly misconceives the basis upon which the Commission used the cost-of-service formula here and upon which the court of appeals affirmed that use. The Commission made clear that it resorted to the cost method in fixing Panhandle's rates not because it felt that the *City of Detroit* case confined it to that method, but simply because it was the only appropriate method of fixing just and reasonable rates for Panhandle *on the record in this case*. While *City of Detroit* can perhaps be read as requiring that in every rate case such as this *some*

[3] The court remanded the proceeding to the Commission for a new determination on the treatment of the profits from the Panhandle's extraction operation at Sneed, Texas, and Liberal, Kansas. In this respect, the court held that it was not clear whether the Commission had acted on an erroneous view of the *City of Detroit* decision. The Commission has not sought review of this determination.

use must be made of the cost rate-base method,[4] the Commission did not adopt that reading in the decisions under review. On the contrary, after referring to the pertinent language of the *City of Detroit* opinion, the Commission stated (R. 429–430):

> * * * The recent case of *Minneapolis Gas Company v. F.P.C.* [294 F. 2d 212 (C.A. D.C.)] indicated that there are many cases in which rate base proof is unnecessary for independent producers with the implication that this might apply likewise to pipeline producers. * * *

Having disclaimed any obligation to adhere to the individual company cost approach in every case, the Commission then disclosed the reason for utilizing that method here (R. 432):

> * * * We think that a new approach is necessary for the pipeline producers as well as the independent producers. In this proceeding, however, we have not established an area price and Panhandle has not shown that it should be allowed the commodity price as an additional allowance over the cost of service. Panhandle must, therefore, depend upon the cost of service evidence with necessary adjustments, as a basis for determining an allowance for its own produced gas.

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[4] See particularly its language (230 F. 2d at 818–819) "* * * though we hold that method not to be the only one available under the statute, it is essential in such a case as this that it be used as a basis of comparison. * * * Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning."

The statement that "a new approach is necessary for the pipeline producers as well as the independent producers" refers, of course, to the area price method of regulating the rates of independent producers upon which the Commission had embarked[5] in September 1960, a few months prior to the *Minneapolis Gas* decision. The Commission's opinion shows that, after *Minneapolis Gas*, it felt as free in pipeline-producer rate cases as in independent-producer cases to depart from the individual-company cost-of-service approach. In short, the Commission refused to depart from the cost method here by allowing anything more with respect to Panhandle's production business because, upon a careful consideration of Panhandle's evidence and arguments, it concluded that the evidence as to

[5] See *Phillips Petroleum Co.*, 24 F.P.C. 537, affirmed *sub nomine Wisconsin* v. *Federal Power Commission*, 303 F. 2d 380 (C.A.D.A.), pending on certiorari, Nos. 72, 73, 74, this Term, and the simultaneously released Statement of General Policy No. 61-1, 25 Fed. Reg. 9578, 24 F.P.C. 818. We wish to make clear that the policy determination that a new approach is necessary to fixing the rates for the gas production business of pipelines, enunciated in this decision, represented the views of the members of the Commission at that time, and that the present Commission, while giving intensive consideration to the problem, has not yet determined the extent to which the emerging area pricing techniques, which it intends to apply to independent producers, should also be applied to the production activities of natural gas pipelines. See *El Paso Natural Gas Co.*, 28 F.P.C. —, 45 P.U.R. 3d 262, petition for review, C.A. 5, No. 20180. But regardless of how the policy determination is ultimately resolved, the present Commission adheres to the position stated in the opinion here that it is legally free to depart from cost-of-service concepts in pricing a pipeline's gas production to the extent that a record presents an adequate basis for moving to a more appropriate pricing basis.

why something more than cost is necessary" was "insufficient" (R. 430).

The court below so understood the Commission and affirmed it on that understanding, and not on the ground imputed to it by petitioner. Whatever justification there might once have been for petitioner's reading of *City of Detroit* as requiring use of the individual-company cost-of-service method, that reading must now be deemed rejected by the court itself. For the grounds (Pet. App. A6) on which the court affirmed the Commission's order on remand were "that the Commission was not obliged *on the record made* to grant a larger allowance than it did, and that it left the door open for a more liberal treatment in future years on a more persuasive record" (emphasis added). Thus, far from regarding the Commission as legally bound to use the cost method, the court approved the Commission's "leaving the door open." And it endorsed the Commission's basis of decision (Pet. App. A6) as "a delicate balancing by the Commission of the interests of the company, its shareholders, the consumer, and the public." No such "balancing" would have been called for if the Commission had been required to adhere slavishly to the cost method. The opinion goes on to recognize expressly the Commission's freedom of selection of method (Pet. App. A6):

> * * * we are unable to say that the method of computation selected by the Commission was unjust, unreasonable, or not conducive to proper exploration and development. * * *

2. Panhandle further claims that the court below erred in upholding the Commission's exclusion from the cost of service for the 1955–1958 refund period of an additional $20 million which Panhandle believes it should have spent for exploration and development, but in fact did not (Pet. 17–20). This contention is without merit.

Panhandle predicates its need for an additional allowance on the ground that it "overproduced" from, or excessively depleted, its gas reserves during the refund period, and would have depleted them still further if it had not resorted instead to short-term purchases from other pipelines (R. 126–138). It estimated that the expenditures which would have been required to find and develop the reserves needed to maintain the deliverability of its supplies—in substance, to replace the reserves taken from the ground and avoid the short-term purchases from other pipelines—was $5 million for each of the four years of the refund period, or $20 million in all. To produce these revenues, Panhandle urges, the Commission's cost allowance of 4.7 cents per Mcf of company-produced gas had to be supplemented by an additional 5.65 cents per Mcf, making a total allowance of 10.35 cents per Mcf—almost exactly the weighted average field price (10.45 cents per Mcf) computed independently on the basis of actual prices paid in 1954. (Pet. 7.)

As the court below held (Pet. 17–20), the Commission's conclusion that it was "not able to found an additional allowance for the produced gas on a hypothetical program of expansion" (R. 430) was entirely

reasonable. So long as the expenditures had not in fact been made, Panhandle was free to conjecture any size program of hypothetical disbursements it wished, and to select at will the objectives of that program. Here it chose to formulate its claim in terms of the amount needed to "maintain deliverability," but it could just as easily have based its hypothetical exploration and development program on a need for gas for the expansion which its pipeline is now undergoing; or to replace existing long-term gas purchase contracts. The Commission properly held that elements of cost of service which remain so completely the subject of the company's free choice are normally better judged on the basis of known performance rather than conjecture.

It should be emphasized that this is not a case in which the Commission is called upon to prescribe rates for the future on the basis of an estimate of what the company's revenue needs will be. Here its task is simply to determine how much the company should be required to refund for a completed period in the past. To include these hypothetical sums in a rate having no effect beyond the refund period would give Panhandle a return in excess of its actual costs, yet at the same time necessarily fail to provide the contemplated amounts for any future period in which Panhandle might yet demonstrate by performance the reality of its estimated needs.

There are further difficulties in Panhandle's claim to a 10.45-cent per Mcf allowance. As the Commission explained (R. 487), the allowance of the hypothetical costs would place a double burden on the refund-period consumers. For, under the cost-of-

service method used by the Commission, in addition to paying the 4.7 cents per Mcf allowed by the Commission for Panhandle's own production, consumers also reimburse the company for the cost of its short-term purchases of gas from other pipelines. If Panhandle's "deferred charge" theory had been adopted to support the additional 5.75 cents needed to bring that allowance up to the commodity value, the consumer would have been saddled with the combined costs of the hypothetical and actual programs, even though if the hypothetical program had been carried out during the refund period, it would have obviated the necessity for the short-term pipeline purchases (R. 153–155).

There is a further, and more important, reason why the claimed cost of the hypothetical program would not, in any event, support the allowance of the rate contended for by Panhandle. A company's outlay for exploration and development consists of both operating expenses and capital costs. Under its prudent-investment-rate-base cost-of-service method of fixing rates, only some of those costs, such as delay rentals, costs of non-productive well drilling, abandoned leases, and developmental geological surveys are treated as operating expenses. (See, R. 510, 511.) Other costs, principally those related to productive wells, are capitalized.[8] The $20 million that Panhandle claims it should have spent, but it did not, consists of both types of outlays; specifically, it includes productive well capital costs of about $12 mil-

[8] Productive well costs are generally capitalized by the industry. See Smith and Brock, *Accounting for Oil and Gas Producers* (pp. 200–202) (1959).

lion and dry-hole and other operating expenses of about $8 million. Thus, if the program had, in fact, been carried out during the refund period, the Commission would only have included in Panhandle's cost of service approximately $8 million, plus depreciation and depletion of, and return on, the $12 million invested in productive wells. But it would not have allowed the principal of the $12 million capital outlay.

In attempting to justify the inclusion of such capital costs as expenses, Panhandle urges, in effect, that once a company has made an investment that results in a well capable of delivering a fixed amount of gas, the consumer should thereafter not only reimburse the company for all its operating expenses (including depreciation and depletion) plus a fair return on the net investment, but should also pay enough more for the gas to provide the company with the additional capital which would enable it, without further investment or risk,[7] to maintain the same deliverability. In effect, this is nothing other than an application of the discredited "fair value" concept[8] in public utility ratemaking, to the determination of depletion and depreciation charges. It would use "replacement cost," in lieu of the prudent investment actually made in gas reserves to compute such charges. Thus the utility,

[7] In its brief in the court below (at p. 35), petitioner made the unsupported assertion that in the gas production business sufficient revenues must be generated to provide capital for perpetual exploration and development without the addition of new investment capital. Why this should be the case is not apparent, since there is no basis for assuming that at least equity capital cannot be obtained in the market even by independent producers.

[8] See *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 601.

rather than recovering its original capital investment over the course of the useful life of the reserves, recovers instead the amounts necessary, at current (and presumably increased) price levels, to replace the capital assets as they are consumed. The contention that the Commission is bound to use this "fair value" technique, in preference to the "original cost" method, was laid to rest by this Court long ago. *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 606–607; *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 593.

CONCLUSION

For the reasons given, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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JANUARY, 1963.

APPENDIX

The Natural Gas Act of 1938, 52 Stat. 821, 15 U.S.C. 717–717w, as amended by Public Law 87–454, 87th Cong. (2d Sess.), S. 1595, approved May 21, 1962, 76 Stat. 72, provides in pertinent part, as follows:

SEC. 4. * * *

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate,

charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the cur-

rently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

* * * * * * *

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